DOCUMENT RESUME

ED 112 753 HE 006 737

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TITLE Investment Policies and Concepts for Pools.
INSTITUTION National Association of Coll. and Univ. Business Officers, Washington, D.C.
PUB DATE Feb 73
NOTE 5p.
AVAILABLE FROM National Association of College and University Business Officers, One Dupont Circle, Washington, D.C. 20036
JOURNAL CIT Studies in Management; v2 n6 Feb 1973

EDRS PRICE MF-$0.76 Plus Postage. HC Not Available from EDRS.
DESCRIPTORS Budgets; Educational Administration; Educational Economics; *Educational Finance; *Financial Policy; Governing Boards; *Higher Education; *Investment; Money Management; Operating Expenses; *Trusts (Financial)
IDENTIFIERS Common Fund; *Smith College

ABSTRACT

Investment and endowment policies for educational institutions are shown to be greatly influenced by the size of the endowment and of the school budget. Administration of pooled funds is discussed with particular reference to procedures at Smith College. Establishment of an independent investment committee, separate from the finance committee, is recommended to determine who will make the investment decisions and to define precisely the objective for the endowment and obtain the board of trustee's agreement. It is emphasized that there is a distinct difference in setting policy and in selecting the individual securities for the portfolio. Specific policies are outlined, as are suggestions for payment options in The Common Fund, a nonprofit membership corporation. The Common Fund allows for the pooling of many small endowment funds of different institutions and the employment of expert management for the investment of these funds. (LBH)

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NACUBO THE COLLEGE and UNIVERSITY BUSINESS OFFICER

February
1973

STUDIES IN MANAGEMENT

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"These policies are an expression of the fiduciary responsibility of the trustees being carried out."

INVESTMENT POLICIES AND CONCEPTS FOR POOLS

By Robert L. Ellis

THERE IS NO single approach to organizing for investing and in the establishment of investment policies. The history, the existing practices, and the background and personalities of your trustees will all have an influence on your investment organization.

Two items will have a great influence on the sophistication of your organization and investment policies:

Size and Importance of the Endowment

In some colleges the income from endowment is a significant resource in balancing the budget. In other colleges it is not. A large college or university with a $5 million endowment and a $50 million operating budget realizes that the difference of a one to two percent return on the endowment amounts to only $50,000 to $100,000, and that this will not have any major impact on its budget. Similarly, the small college with one million dollars of endowment cannot significantly alter its financial picture through a greater optimization of its investment income.

At a college like Smith, where our endowment now exceeds $90 million, the endowed funds constitute a significant resource which deserves a good deal of attention because it provides approximately twenty percent of our operating funds. A 1969 Phillips Exeter special report on *Investment and Endowment Policy* pointed out that historically their endowment had contributed forty to forty-five percent of their annual income, an amount about equal to the income realized from annual, comprehensive student fees.

Total Return Concept

Whether or not you, your investment committee, trustees, and your college attorney believe in the investment philosophy best described as the Total Return Concept (TRC), will greatly influence your investment organization and policies. For purposes of discussion here, TRC includes the use of a modest portion of realized gains to supplement interest and dividends for operating purposes.

The philosophy of the TRC is to avoid the constraint that has hampered endowment managers during the last decade, that constraint being the pressure for current income. Under TRC the investment manager invests to achieve the maximum average return (both appreciation and yield) over the long term. Such a plan relieves the investment manager of pressure to select securities offering a current high yield. Under an ideal system he can select securities that pay little or no dividends. However, in order to provide current income for the college's operations, the trustees authorize the treasurer to use a prudent percentage of the average market value of the endowments. It is here that the problem arises because many lawyers still take the position that a true endowment is a trust fund and, under trust law, market appreciation belongs to principal and cannot be used as income.

For a thorough discussion of TRC I recommend the following two Ford Foundation Reports: *Managing Educational Endowments*, and *The Law and the Lore of Endowment Funds*. Both reports were published in 1969 and are due to be reprinted soon. If you are considering TRC, I recommend that copies of both reports be made available to the members of your investment committee.

Administration of Pooled Funds

The Ford Foundation Report points out that it is most important that the board of trustees accept management of the endowment as one of its responsibilities. The Report further recommends the establishment of an independent investment committee, separate from the finance committee.

The two prime functions of the Investment Committee are to determine who will make the investment decisions, and to define precisely the objective for the endowment and obtain the board's agreement thereto.

Historically there have been three possible methods of

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portfolio management. A fourth possibility now exists with the establishment of The Common Fund which is discussed below. The traditional three methods are:

* Appoint a Trustee who is also a professional investment manager. This is not, in my opinion, a good alternative excepting in the case of a very modest fund and a situation where the trustee can devote sufficient time to its management. While it is true that there are many trustees at colleges and universities who are highly competent in investment matters, the assignment of investment decision responsibilities to one such individual could present many problems. For example, as the term of the trustee expires, a decision must be reached as to whether or not to continue having the trustee exercise such a responsibility. If the answer is yes, then the relationship between the individual and the board could become awkward. On the other hand, should it be a requirement that the investment decisions be made by a trustee, then it would be necessary to assign the responsibilities to another trustee. This raises the question as to whether or not the composition of the board is such that another trustee equally as competent in investment matters is available for the assignment.
* Hire your own full-time manager and typically two or three assistants if you have a sufficiently large endowment, perhaps a minimum of $50 million.
* Retain a paid, outside investment management organization to run the portfolio. Here the role of the investment committee is to choose the advisor, define policies and procedures, and judge the results. This is the most commonly used system and the one used by Smith College.

The Ford Foundation Report further recommends that decision-making authority be delegated to the chosen investment advisor. Otherwise there will be delays in making Buy-Sell decisions and the decisions when made often represent a compromise of several opinions.

Investment Policies

Once the portfolio management method has been determined and the investment advisor selected, the Investment Committee should meet with him to explore and define the best possible policies and procedures. *It should be clear that there is a distinct difference in setting policy and in selecting individual securities for the portfolio.*

Robert Barker, in his preface to the second edition of the Ford Foundation Report, emphasizes the importance of focusing carefully beforehand upon how a portfolio may behave during severe market fluctuations and the acceptability of such behavior to the Trustees. He states that the emotional strains of living with greater than average volatility are severe. The trustees may find it preferable to face the facts and accept a modestly lower rate of return than would otherwise be attainable, in order to lessen the risk of subsequent erratic shifts. He concludes that full advance understanding will strengthen the ability of all concerned to make the best possible selection and to stay with that selection during periods of doubt.

I checked a half-dozen private college treasurers to obtain copies of their written investment policies but found that none had committed their policies to writing. While they promised to research their investment committee minutes to ferret out policies which had been enunciated at their meetings, to date I have not heard from a single one of them. I can only conclude that not many colleges have written investment policies.

At Smith College the following policies are presently in effect:

* The investment objective is to obtain the maximum average rate of return over the long term.
* The Treasurer is authorized to use 4½% of the three year average market value of the pooled investment fund as endowment income. Any excess required beyond the yield earned is taken from market appreciation either realized or unrealized. In short, Smith uses the TRC.
* The Investment Advisor, Morgan Guaranty Trust Co., (MGT) has discretionary authority to buy or sell subject to telephone confirmation with the Chairman of the Investment Committee if he is available. If he is not available, MGT can take immediate action. This largely eliminates divided responsibility for the portfolio performance.
* The College will support the Common Fund through investment of $5 million as a Charter Member.
* For the present the College is committed to a belief in the future of equities with a higher level of risk and performance. The Trustees have been notified that this policy involves a more volatile situation which could show up in a strong market downswing.
* Equity investments have tended to be limited to about forty holdings on the theory that the position in each equity should be large enough to secure a substantial reward when a judgment on a holding proves accurate.
* Equities will be held only as long as the future of the general industry and the particular company are favorable.
* The portfolio will not be operated on a "go-go" basis. Investments are made based upon long term confidence. This does not mean that certain holdings will not be liquidated temporarily if a sharp bear market is in the offing.

* Social Responsibility Dimension of Investing:

(1) While maximum economic return should be the primary investment consideration, the Trustees may exclude from consideration certain corporations or industries on the basis of moral or legal considerations.

(2) Once a security is purchased, the Trustees accept the role of interested investors and will express opinions in either written or verbal communications to the management or by voting of the proxy.

(3) Chairman of Investment Committee is charged with routine voting of proxies. In controversial areas he will seek guidance from other members of the Investment Committee and the College Committee on Planning and Resources. Final decision will be made in these cases by the full Board of Trustees or the Executive Committee.

I hasten to say that not all of these policies have been written.

Phillips Exeter

The 1969 investment guidelines and policies of Phillips Exeter were published as follows:

* The portfolio need not produce more than $1.5 million of dividends and interest (2.3 percent yield).
* Seventy-five percent of the portfolio should be in equities (includes convertibles).
* Up to ten percent can be invested in special situations.
* Overall goal of a twelve percent average compound return is established.
* Standardized performance data is to be provided.

The August, 1972 issue of the *Institutional Investor* reports that the New York State Insurance Department has come up with a list of investment guidelines that Trustees of jointly trusted welfare and pension funds must establish, and within which their investment advisors must work. Along with the standard prohibitions against buying stock options, puts, calls, arbitrage and short sales, the guidelines require trustees to:

* Set maximum percentages of fixed-dollar amounts of their funds that can be put into debt securities, industry groups, stocks of any one company, or cash.
* Specify that the fund can only invest in companies with a certain record of earnings and dividends over a specified time.
* Meet regularly with advisors to discuss holdings and investment activity.

The Common Fund

The college with a small endowment can possibly resolve its portfolio management problem by placing all of its investment in The Common Fund, a non-profit membership corporation, which began operations on July 1, 1971. Many colleges with larger endowments, including Smith, have invested a part in The Common Fund.

The Common Fund is an outgrowth of the Ford Foundation Report, *Managing Educational Endowments*. Its purpose is to provide non-profit member colleges, universities, and independent schools with professional management of their endowment funds and other funds held for long-term investment. The Ford Foundation has made a commitment of up to $2.3 million in grants to cover organizational costs, investment management expenses, custodial fees, and all other costs of operation through 1973. In addition, the Foundation has provided a $500,000 grant to underwrite a program of research and publication in matters relating to the fiscal management of educational institutions. Thus, it is essentially free of cost to its members during the high-cost, start-up period. The Fund is not appropriate for short-term funds and cannot accept funds which are subject to life income agreements.

The Common Fund allows for the pooling of many small endowment funds of different institutions and the employment of expert management for the investment of these funds. The objective is to allow all educational institutions to achieve investment results comparable to those attained by the better managed college and university endowment funds. The investment objective is to obtain an above average, long term total rate of return, consisting of both current yield and capital appreciation. The portfolio is invested primarily in common stocks and other marketable securities with equity characteristics.

Payment Options

The minimum initial investment is $100,000 with a high overall limit of $10 million. The institution may withdraw all or part of its investment at the end of any month, on sixty days notice. Members may elect any one of the following payment options:

(a) Quarterly payments of 1¼ percent of average unit value.

(b) Quarterly payments of accrued yield only.

(c) Quarterly payments of a fixed dollar amount.

(d) No quarterly payments; all earnings reinvested in Fund.

On June 30, 1972, at the end of the first year of operation, The Common Fund Unit Value had risen from $1,000 to $1,097.63, a gain of 9.8 percent versus an increase of 7.5 percent for the S & P index. In addition, a unit held for the entire year would have earned $28.08, or 2.8 percent per unit. On July 1, 1971 there were 72 charter members; on July 1, 1972 the membership totaled 228 institutions with pooled funds of $176,918,431 at market value.

Complete information on The Common Fund may be

obtained by writing to: The Common Fund, 635 Madison Avenue, New York, New York 10022.

The development of investment policies is important in two respects. It serves as a vehicle to transfer guidance from the board of trustees to an external fund manager, whether it be an investment company or a bank. Therefore, these policies in effect are an expression of the fiduciary responsibility of the trustees being carried out. The second important aspect involves continuity among changing board members. While persons of varying philosophies are appointed to and retire from boards of trustees, the written policies continue on.

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